No. 10292

In the United States Circuit Court of Appeals for the Ninth Circuit

BABOQUIVARI CATTLE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 29–50) which is reported in 47 B. T. A. 129.

JURISDICTION

This petition for review (R. 51–57) involves federal income taxes for the years 1937 and 1938 in the respective amounts ~~about~~ of $795.60 and $424.46 On April 20, 1940, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency in the total amount of $1,220.06. (R. 11–17.) Within ninety days thereafter and on July 18, 1940 (R. 1), the taxpayer filed a petition with the Board of Tax Appeals for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code (R. 4–11). The decision of the Board of Tax Appeals sustaining the respective deficiencies was entered June 16, 1942. (R. 50.) The case is brought to this Court by a petition for review filed September 14, 1942 (R. 51–57), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code. As of October 22, 1942, by Section 504 of the Revenue Act of 1942, the name of the Board of Tax Appeals was changed to The Tax Court of the United States. Although the decision of the Board and the petition for review were both filed prior to that date, since the record was printed subsequent thereto by the clerk of this Court he captioned the record a "Petition for Review of Decision of The Tax Court of the United States".

QUESTION PRESENTED

Whether benefit payments made to the taxpayer corporation by the Federal Government at the end of each year for complying with established range-improvement practices constituted taxable income under the broad provisions of Section 22 (a) of the Revenue Acts of 1936 and 1938.

STATUTES INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever

form paid, or from professions, vocations trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:

* * * * *

(3) *Gifts, Bequests, and Devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income);

* * * * *

(The corresponding provisions of the Revenue Act of 1938 c. 289, 52 Stat. 447, are the same.)

STATEMENT

Taxpayer, an Arizona corporation engaged in the operation of a cattle ranch and keeping its books upon the accrual basis, filed its returns with the Collector of Internal Revenue for the District of Arizona. The ranch comprises 57,200 acres of land in Pima County, Arizona, 45,880+ being owned by the state, 4,000 by the United States and 7,319+ by taxpayer. During the taxable years, the land owned by the state was held by taxpayer under grazing leases duly executed under the laws of Arizona for terms of from five to ten years and the land owned by the United States was held by taxpayer under the provisions of the Taylor Grazing Act of June 28, 1934, c. 865, 48 Stat. 1269, as amended. The land is in a hot, semiarid region in the watershed of the Gila River, a tributary of the Colorado River. The major portion of the rainfall occurs during three summer months and because of climatic and geographical conditions, the lands owned or held by taxpayer and surrounding lands are subject to substantial erosion. (R. 29–30.)

During the taxable years, taxpayers constructed or rebuilt on the ranch some dirt reservoirs and earthern tanks, constructed a rubble masonry dam, built two miles of drift fence, deepened a well, and developed a spring or seep. Before these improvements were undertaken, a range grazing examiner, working in conjunction with the Pima County Range Conservation Committee, had made a survey of taxpayer's ranch and a report recommending that the improvements be made. The first report was approved by the committee on or about July 16, 1937. On that date, the committee advised taxpayer in writing (R. 30–31):

> Upon notification by you * * * that one or more of these recommended improvements have been completed, the County Committee will inspect same and upon approval, will submit to you an application to be signed for benefit payment.

The letter also advised taxpayer, in accordance with the Soil Conservation and Domestic Allotment Act, c. 85, 49 Stat. 163, as amended, and the regulations issued thereunder: "Number of animal units 2325 which times $1.50 per head, will enable you to earn a maximum payment of $3,487.50." Substantially the same procedure was followed in 1938, the total allowance, computed upon the number of acres and number of animal units, being $3,247.74. (R. 31.)

Upon completion of a portion of the work in 1937, the contemplated notification was given, application was filed and approved, and payment was authorized and made to taxpayer in the amount of $3,586.89. Upon completion of the remainder of the work in 1938, payment was made in the amount of $3,247.74. The cost of the work in each year exceeded the amounts received by taxpayer from the United States. In taxpayer's books of account, the cost of the improvements was not charged to profit and loss, but was treated as a capital item and carried into an asset account entitled "Improvements under Federal Aid". The amounts received by taxpayer in the taxable years were treated as credits to capital surplus. In its returns of income, the amounts were shown as carried upon taxpayer's books, but neither was included in its gross income. The Commissioner added each of them to the net income reported. (R. 31–32.) The Board of Tax Appeals sustained this action. (R. 50.)

SUMMARY OF ARGUMENT

The benefit payments made to the taxpayer corporation by the Federal Government were in consideration of compliance throughout the tax years in question with established range-improvement practices. Such payments fall within the general concept of income, and since Congress, in providing for their payment, granted no exemption as it did in other situations, exemption cannot be presumed. The Board of Tax Appeals properly concluded that such payments must be returned as income.

ARGUMENT

The Board of Tax Appeals properly concluded that benefit payments made to the taxpayer corporation by the Federal Government for complying with established range-improvement practices, constituted taxable income

While we do not intend in any way to challenge the wisdom of benefit payments on the part of the Federal Government, it appears pertinent to observe, at the outset, that it seems strange if not startling to see a taxpayer corporation which is annually enjoying large benefit payments come into court and ask to be relieved of paying the same rate of income tax on them which less fortunately situated citizens are required generally to pay on regularly earned income. Periodically, lists are published showing the many thousands of dollars paid under farm benefits to large corporations, principally land holding insurance and mortgage companies. It seems almost catastrophic to even contemplate exemption of such payments from income tax. It has been the consistent position of the Bureau of Internal Revenue that such payments constitute income. I. T. 2992, XV–2 Cum. Bull. 75 (1936); I. T. 3379, 1940–1 Cum. Bull. 16. The fact that the instant case is the first one of its type seems indicative of the general acceptance by taxpayers of the administrative ruling.

It should be noted that Section 22 (a) of the Revenue Act of 1936, *supra*, is about as comprehensive as language permits, and that Congress plainly intended to reach gains and profits of every description. *Irwin* v. *Gavit,* 268 U. S. 161. Here, under the test laid down in *Eisner* v. *Macomber,* 252 U. S. 189, the gain is coming in, being derived, or proceeding from the capital and labor of the taxpayer and, accordingly, falls within the generally accepted definition of income.

Since the benefit payments here undoubtedly fall within the broad concept of income, it is incumbent upon the taxpayer to show that they fall within one of the exemption classes. It is fundamental in tax law that exemptions are to be narrowly construed. Congress made provision for the benefit payments here while the income tax laws were in full force and effect. Since Congress did not see fit to incorporate in the Act a provision exempting benefit payments from the usual income tax, the conclusion that it intended them to be taxed seems inescapable. See *United States* v. *Stewart,* 311 U. S. 60.

The situation involved in *Seas Shipping Co.* v. *Commissioner*, 1 T. C. No. 7, referred to by the taxpayer (Br. 14), lends definite support to the Government's position here. The payment there made to the taxpayer was not exempt merely because it was a subsidy, but because its general use was withheld from the taxpayer and Congress specifically said that to the extent of the payments so withheld, no federal tax should be imposed. Congress specifically provided, however, in the same section that if and when the payments were withdrawn from the special reserve fund, they should be taxed. That statute was enacted in 1936, at about the same time as the statute providing for the benefit payments in the instant case. The fact that Congress included a limited exemption in the one statute and failed to make any such provision in the latter statute, indicates that such payments were generally contemplated as falling within the taxable income category.

The taxpayer argues (Br. 12–15) that the payments here were subsidies and draws the conclusion that they, accordingly, fell outside the income category, as if the word "subsidy" were a magic touchstone sufficient of itself to furnish relief. In both *Helvering* v. *Claiborne-Annapolis Ferry Co.*, 93 F. 2d 875 (C. C. A. 4th), and *Lykes Bros. S. S. Co.* v. *Commissioner*, 126 F. 2d 725 (C. C. A. 5th), the payments were treated as subsidies but were nevertheless included as taxable income.

The taxpayer further argues in this connection that (Br. 31–32) the payments may be construed to be gifts and, therefore, exempt under Section 22 (b) (3), *supra*. In view of the nature and purpose of the payments, it seems obvious that they do not fall in the category contemplated by Congress in the above exemption statute. The very theory of the legislation was that the Government and the farmer or rancher should cooperate in preventing soil erosion. The pertinent regulations, hereinafter discussed, made it very specific that the benefit payments were to be made only if earned. Designated payments were made at the end of each year upon a showing that the rancher had complied with established range-improvement practices. In order to qualify for the benefit payments, the rancher was required not only to make certain positive improvements, but also to refrain from engaging in any range practice which would offset the benefits derived from the improvements. Clearly the rancher, in meeting these terms and conditions, furnishes sufficient consideration to take the payments out of the category of pure gifts. In *Allen* v. *Smith*, 173 U. S. 389, the court said (p. 402):

> Bounties granted by a government are never pure donations, but are allowed either in consideration of services rendered or to be rendered, objects of public interest to be obtained, production or manufacture to be stimulated, or moral obligations to be recognized.

It seems equally clear that the benefit payments were not exempt from income tax as mere capital contributions, as the taxpayer argues. (Br. 15–30.) The payments were made primarily in recognition of active cooperation with the National Soil Erosion and Improvement Program and as a result of compliance by the taxpayer corporation with established range-improvement practices. The taxpayer (Br. 30) points to the fact that the improvement practices followed by it in the years now before the court, such as the construction or repair of reservoirs, dams, wells, and fences were all items of a capital nature. The suggestion is made that a distinction is justifiable, even if it be conceded that benefit payments based upon other types of improvement or compliance should be taxed. Such a suggestion ignores the general nature and purpose of benefit~~s~~ payments. The Government was not making a contribution to capital as such. The payments were not directly commensurate with the work done or money spent in making a particular capital improvement. The lump sum allowance was paid to the respective ranchers, in an amount fixed by the acreage and livestock units involved, after a showing had been made that a minimum number of the prescribed range-improvement practices had been carried out, plus a showing that no offsetting bad practices had been followed. The basis of payment is well summarized in the following excerpt from the 1938-39 report of the Agricultural Adjustment Administration (p. 22):

> Under the range program, an allowance is established for each participating ranch. The allowance is determined on the basis of the number of animal units which the ranch is capable of carrying and the number of acres in the ranch. The rancher may earn this allowance by carrying out practices at rates of payment established for various range-improving practices included in the range conservation program.

The pertinent regulations [1] issued by the Secretary of Agriculture specifically provided that the rancher

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[1] Federal Register, Tuesday, July 27, 1937, p. 1300:

1937 AGRICULTURAL CONSERVATION PROGRAM—
WESTERN REGION
(WR Bulletin No. 101—Arizona—Supplement 2)

Part VI, Section 3, is amended to read as follows:

SECTION 3. *Payments Restricted to Effectuation of Purposes of the Program.*—No person shall be entitled to receive or retain any part of any payment if such person has adopted must not only make specified improvements on the range, but must also refrain from following offsetting practices in order to qualify for the benefit payments. Let us suppose, for example, that after increasing the water supply and otherwise improving its range, the taxpayer here doubled the number of cattle and thus greatly enhanced its current income. It would, of course, be taxable on the income thus received. However, under the prohibition against offsetting bad range practices, it would forfeit its right to any benefit payments, since it would be guilty of violating the grazing capacity fixed by the regulations. Suppose, instead, that the taxpayer made the range improvements and continued to follow the recommended range practices so as to qualify for the benefit payments. In a practical sense, these payments make up or supplement the operating income which might otherwise have been realized, much the same as the Government payments supplemented the operating income of the railroad in *Texas & Pacific Ry. Co.* v. *United States,* 286 U. S. 285.

Throughout the pertinent regulations and reports dealing with the administration of this program, the payments are spoken of as being "earned". The 1936

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any practices which the Secretary determines tends to defeat any of the purposes of the 1937 Program, or if such person has offset, or through any schemes or devices whatsoever, such as but not limited to operating by or through or participating in the operation of a firm, partnership, association, corporation, estate, or trust, has participated in offsetting, or has benefited or is in position to benefit by such offsetting, in whole or in part, the performance rendered in respect of which such payment would otherwise be made.

report of the Agricultural Adjustment Administration made this analysis (pp. 42, 52):

> In 1936 the Agricultural Adjustment Administration made studies and held hearings in developing a program to help ranchers work out better grazing methods for the range land under their control. * * *
>
> This program provided that ranchers could earn payments by adopting a wide variety of range-building practices, if the practices were approved by the county committee and a competent ranch examiner; and provided that the total payments earned on any ranch should not exceed $2 per animal unit on its established grazing capacity.
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> * * * * *
>
> The 1937 program for range lands in the livestock grazing regions of the West and Southwest, is similar to the 1936 program, except that the maximum range-building allowance which can be earned for a given ranch is limited to $1.50 per animal unit of the normal carrying capacity of the ranch; * * *

It seems clear that the payments were not gifts or contributions to capital in the technical tax sense, but were in consideration of compliance with a prescribed course of conduct. The compliance consumed capital and labor. The payment here in question flows from such use of capital and labor and meets the general definition of income in *Eisner* v *Macomber, supra.* Other income will also result from such combined use of capital and labor, in the form of increased production or yield of livestock which will presumably result from the improved practices.[2] Both kinds of income must be returned by the taxpayer. Offsetting this combined income will be the

[2] 1938 report of Agricultural Adjustment Administration (pp. 24, 36):

> An important byproduct of the range conservation program is the opportunity it gives range operators to learn the value of practices which they otherwise would have to postpone or not do at all. * * *
>
> * * * * *
>
> In many range areas where drought has been severe, the range program has played an important part in enabling ranchers to retain their livestock. Under similar weather conditions in 1934, many of the same ranchers were forced to sell and ship their breeding stock because of lack of feed and water.

1939 report of Agricultural Adjustment Administration (pp. 6, 14):

> In the western range country, ranchmen cooperating in the range conservation program have restored and protected range forage through range-building practices. In the early years, the program emphasized better distribution of livestock and more uniform utilization of range forage. More recently there have been large increases in natural and artificial reseeding practices and measures for promoting water conservation and run-off control.
>
> From the beginning, the program has pointed more and more at the conservation problems of the individual ranches. The program has made it possible for many range operators to develop plans of operation that make for more conservation, improvement, and increased efficiency of each ranching unit.
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> * * * * *
>
> Thus, a combined total of $709,053,000 was added to the cash income of the Nation's farmers for their 1939 adjustment efforts. In qualifying for this cash aid, farmers also were storing in their soil the accruing benefits of a conservation system of farming.

usual depreciation allowances with respect to such of the practices as may constitute capital improvements. Smaller items of a current nature are, of course, compensated for by annual deduction of expenses.

It is interesting to note in this connection that in computing the level of farm income, the Department of Agriculture usually consolidates the benefit payments with the farmer's other income. The 1937 Report of the Secretary of Agriculture makes this statement (p. 44):

> Cash farm income, including Government payments for soil conservation, is likely to amount to nearly $9,000,000,000, or about 87 percent of the average for the predepression period 1924-29. With Government payments left out of the reckoning the income would be about 82 percent of the predepression average.
>
> This income will have a buying power equal to that of the predepression years. Prices of the goods and services that farmers commonly buy were about 14 percent lower in 1937 than they were in the period 1924–29. Hence, $9,000,000,000 cash income in 1937 would have about the same purchasing power as $10,000,000,000 in 1924 to 1929.

A more detailed statement of this period is made in the 1937 report of the Agricultural Adjustment Administration (p. 50):

> Soil conservation payments disbursed in 1937 contributed approximately $367,000,000, or more than 4 percent of the total farm cash income for that year. A large portion of the payments disbursed during 1937 was earned

> by compliance with the program of 1936, and a large portion of payments earned in 1937 was disbursed in 1938 and consequently was not included in 1937 cash income.

Note that the above excerpts speak of the benefit payments as constituting a certain percentage of the "total farm cash income", which were "earned by compliance with the program". In a recent press release, it was stated that "cash farm income, including Government benefit payments, is estimated at $15,600,000,000 for 1942". It is inconceivable that a considerable portion of this huge amount, representing benefit payments, should be treated as exempt from income tax.

The taxpayer predicates its case almost entirely upon *Edwards* v. *Cuba Railroad,* 268 U. S. 628. (Br. 15–28.) The facts of that case are unique and the rule there announced has been sparingly applied. During the years 1911 to 1916, the Republic of Cuba turned over to the railroad company large sums of money and considerable physical properties such as lands, buildings, and equipment which the Republic had acquired in an earlier effort to build the railroad. Specific concessions were made to the Republic of Cuba with respect to the future use of the railroad. No attempt was made to include the value of the physical properties as income. Under the circumstances, the court ruled that the cash payments could not be treated as income. The court pointed out that the funds were to be used directly to complete the building of the railroad and that the arrangement indicated a purpose on the part of the Republic of Cuba to contribute to the taxpayer's capital, rather than to pay it for services rendered. The decision has been severely criticized,[3] and the Supreme Court itself has restricted its applicability. In *Texas & Pacific Ry. Co.* v. *United States,* 286 U. S. 285, the court distinguished its *Cuba Railroad* decision and ruled that a payment made by the Federal Government to the railroad to supplement operating income for the period following relinquishment of federal

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[3] See Magill, Taxable Income (1936), 340–342; Rottschaefer, Concept of Income in Federal Taxation, 13 Minn. L. Rev. 637, 669. The latter author had this to say in criticizing the *Cuba Railroad* decision (p. 669):

> The reasons assigned were that they were intended to reimburse the company for its capital outlay, and that nothing indicated that they were to be used for dividends, interest or anything else properly chargeable against earnings. It may be quite true that the payments were intended to reimburse the company for its capital outlay, but the fact remains that at the close of the transaction the company still owned that capital and had the subsidy in addition. Presumably the company would in future years charge rates sufficient to take care through depreciation charges to be again reimbursed for its capital so far as others used it, and that its own net income for tax and other purposes would reflect those facts. The result would be that it would be allowed to convert tax free an amount of capital in excess of that contributed by itself, that is, in excess of the cost to it of that capital or of the March 1, 1913, value of its own capital contribution. This result, which amounts to a double reimbursement for its capital outlay, would have been avoided by treating the subsidies as income either in the years of their receipt or in some or all of the years of future operation. The only other way to avoid it would be to restrict future depreciation charges so as to prevent the recovery through rates of more than the cost or value of its own capital contribution.

control was taxable income. See also in this connection *Helvering* v. *Claiborne-Annapolis Ferry Co.*, 93 F. 2d. 875 (C. A. A. 4th), and *Lykes Bros. S. S. Co.* v. *Commissioner*, 126 F. 2d 725 (C. A. A. 5th). In the case last cited above, a similar argument was made and rejected by the court. The taxpayer there sought to avoid tax on a part of the Government payment because it was, indirectly at least, required to be used for capital purposes. The court there concluded that, while the taxpayer was bound to make certain capital improvements, the payment in question was not earmarked for that purpose, but was paid to the taxpayer in consideration of the performance of certain prescribed operations during each year. So, in the case at bar, the benefit payments were made to the taxpayer at the end of each year in consideration of its compliance with certain established practices and, irrespective of bookkeeping entries of the taxpayer, the payments were in fact income which could be used by the taxpayer for whatever purpose it saw fit.

The development of our income tax law indicates that "taxable income" is not a term that can be successfully defined so as to be binding for all time. The law of income taxation is dynamic, not static. "It is constantly developing, constantly changing, to meet the changes in our economic and political life." 1 Mertens, Law of Federal Income Taxation (1942) 161. Cf. *Helvering* v. *Producers Corp.*, 303 U. S. 376, with earlier Supreme Court decisions on that subject. We respectfully submit that the Board of Tax Appeals correctly treated the benefit payments as taxable income.

CONCLUSION

The decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted,

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